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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1964

No. 944

F. & W. CORPORATION,
Petitioner,

vs.

CHARLES M. LOKEY, TRUSTEE IN BANKRUPTCY FOR CAPITOL TOBACCO COMPANY,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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INDEX

Opinions Below 1
Jurisdiction and Date of Opinion 2
Questions Presented 2
Statement of the Case 2
Reasons for Granting the Writ 6
Certificate of Service 16
Appendix—
Opinion of the United States Court of Appeals for the Fifth Circuit A1
Judgment of the United States Court of Appeals for the Fifth Circuit A2

Citations

Cases

Arnold v. *Phillips*, 117 F.2d 497 (1941) 2, 5, 7, 9, 10, 11, 12

F. & W. Corp. v. *Lokey*, 338 F.2d 341 (1964) 1

In re Garfield Bag and Stationery Company, 42 F. Supp. 708 13

In re George R. Burroughs, Inc., 156 F.2d 640 13

In re Pringle Engineering and Manufacturing Co., 164 F.2d 299 13

Missouri Printing and Engraving Co. v. *Crippen*, 224 F.2d 297 12-13

Moorfield et al. v. *Fidelity Mutual Life Insurance Company*, 135 Ga. 186 14

Paschal v. *Bluden*, 127 F.2d 398 13

Pepper v. *Litton*, 308 U.S. 295 (1939) 2, 5, 6, 7, 8, 9, 10, 11, 12

St. Louis Union Trust Company v. *Champion Shoe Machinery Company*, 109 F.2d 313 15

Thompson v. *Randall*, 173 Ga. 696 13

Statutes

11 U.S.C. 11 et seq. 6

28 U.S.C. 1254 (1) 2

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CHARLES M. LOKEY, TRUSTEE IN BANKRUPTCY FOR CAPITOL TOBACCO COMPANY,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

F. & W. Corporation does hereby petition for a writ of certiorari to review the judgment of the Court of Appeals for the Fifth Circuit entered on November 30, 1964, affirming the judgment of the United States District Court for the Northern District of Georgia.

OPINIONS BELOW

The opinion of the Court of Appeals (Tr. 633)[1] is reported at 338 F.2d 341 (1964); the decision of the District Court (Tr. 132-134) is not reported; the opinion of the Referee is not reported (Tr. 56-77).

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1. "Tr." refers to certified transcript of record.

JURISDICTION AND DATE OF OPINIONS

The judgment of the Court of Appeals was entered on November 30, 1964. Jurisdiction of this Court is based upon the provisions of 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the Court of Appeals, in affirming the decision of the District Court denying the claim of F. & W. Corporation, which claim was based upon a note and deed to secure debt for which valuable consideration was given and which claim was made to funds held by the Trustee in Bankruptcy obtained from the sale of bankrupt's property free and clear of liens including the deed to secure debt of petitioner, and subordinating said claim to the Trustee, was a completely unwarranted extension of the doctrine announced by this Court in *Pepper* v. *Litton*, 308 U.S. 295, 60 Supreme Court Reporter 238 (1939) and in conflict with the decision of *Arnold* v. *Phillips*, 117 F.2d 497 (5th Circuit). Also whether the instant case was a situation that this Court did not intend the doctrine of *Pepper* v. *Litton*, *supra*, to apply. And finally whether the evidence adduced at the bankruptcy hearings in this matter was properly allowed over objections of your petitioner.

STATEMENT OF THE CASE

This case arises out of the bankruptcy proceedings of Capitol Tobacco Company, pending in the United States District Court for the Northern District of Georgia, Atlanta Division.

The bankrupt was the owner of certain property located at 2121 Plaster Bridge Road, Atlanta, Georgia. The property was subject to outstanding notes secured by deeds to secure debt. F. & W. Corporation was the owner of one such note and deed to secure debt (Tr. 4-11).

Referee in Bankruptcy, Walter R. Phillips, after adjudication of the above bankrupt, ordered that the 2121 Plaster Bridge Road property be sold "free and clear of liens" with liens to attach to the proceeds. F. & W. Corporation filed its claim (Tr. 1-3) based upon the note and deed to secure debt in the amount of Fifty three thousand three hundred eighteen ($53,318.00) Dollars, plus interest, from July 1, 1962.

To this secured claim the Trustee filed objections (Tr. 12-20). His objections included generally the points of subordination, estoppel, wrongful disbursement of funds to favored pre-existing creditors and receipt of preferences.

The note and deed to secure debt in this case originated when S. W. Allen, Jr., as owner of the property executed a note and deed to secure debt in favor of CMS Realty Company in consideration of the sum $50,000.00 on April 15, 1959. On October 17, 1960, CMS Realty Company transferred its interest in the note and security deed to Rupert L. Hogan. Rupert L. Hogan transferred his interest therein to Zack D. Cravey, Sr., which transfer was recorded on January 31, 1962. On January 31, 1962, Zack D. Cravey, Sr., transferred his interest therein to your petitioner, F. & W. Corporation. The bankrupt corporation had previously purchased Allen's interest in the property and assumed the payment of outstanding note and deed to secure debt.

The matter of the Trustee's objections to the claim of F. & W. Corporation came on for hearing before Walter

P. Phillips, Referee in bankruptcy who, after receipt of evidence over an extended period of time, issued his findings of facts and conclusions of law (Tr. 56-77).

The findings of fact found that Capitol Tobacco Company, the bankrupt, had acquired the real estate in question from Scott W. Allen, Jr. and assumed the existing indebtedness on the property including that represented by the note and security deed held by your petitioner (Tr. 57). The Referee found that F. & W. Corporation, your petitioner, was a family corporation whose stockholders were Zack D. Cravey, Jr., Robert Cravey and John L. Taylor, and that Cravey, Jr. and Robert Cravey were sons of Zack D. Cravey, Sr. (Tr. 58). It was found that the original consideration for petitioner's note and deed to secure debt was $50,000.00 (Tr. 59).

That CMS Realty Company, the original holder of the note and security deed transferred same to Rupert L. Hogan who arranged for the purchase through a North Carolina Bank. Hogan transferred the note and security deed in blank on the same day he received it from the original holder. The money used by Hogan to purchase the note was borrowed by one W. A. Lloyd and secured by the personal endorsement of Zack Cravey, Sr., and securities of his wife and brother-in-law (Tr. 60-61). That at the time the Trustee qualified, there was no equipment, merchandise, or inventory found on premises of bankrupt except for miscellaneous stationery supplies. That of the initial stock issuance, 400 shares belonged to Georgia Southern Corp., and 100 shares to John L. Taylor. Taylor professed to know nothing of the original stock (Tr. 62-63). The certificate for 100 shares belonging to Taylor allegedly contained handwriting of Zack D. Cravey, Sr., on the reverse side. The Referee found that Zack D. Cravey, Sr. and Zack D. Cravey, Jr., were actually stockholders in the

bankrupt corporation. That Zack D. Cravey, Sr., influenced J. D. McIntosh to invest in the bankrupt corporation. That Fulton Properties, Inc., a corporation owned by the same individuals that owned your petitioner's corporation, invested in Capitol Tobacco Company. That balance sheets reflected a paid in capital of $125,000.00 in the bankrupt, when the record does not reflect that sum to have been paid. That certain individuals controlled, directed and managed the bankrupt corporation including Zack D. Cravey, Sr., Zack D. Cravey, Jr., John L. Taylor, W. A. Lloyd, Paul L. E. Helliwell, Robert Strauss, Harold Karp, James R. Kaufman, and Scott W. Allen. That all of the above caused false financial statements to be circulated among creditors, defrauded creditors, wrongfully disbursed funds, failed to locate corporate books and failed to explain the location of wrongfully disbursed funds. That F. & W. Corporation is the same corporation as Fulton Properties, Inc. and is not a bonafide purchaser of the note and security deed.

The Referee then concluded that the claim of F. & W. Corporation should be subordinated to the Trustee, applying the doctrine of *Pepper* v. *Litton*, 308 U.S. 295 (1939) and *Arnold* v. *Phillips*, 117 F.2d 497 (5th Cir. 1941). The Referee further concluded that as petitioner was in effect the same entity as Fulton Properties, Inc., petitioner was bound by a subordination agreement executed by Fulton Properties, Inc., in favor of a general creditor (Tr. 76-77).

Your petitioner filed its petition for review (Tr. 78-131) setting forth the specifications of error in the Referee's finding of fact and conclusions of law and, in addition, certain errors regarding rulings on the admission of certain documentary evidence and testimony.

The petition for review was presented and argued before District Judge Frank A. Hooper who affirmed the

rulings of Referee Walter R. Phillips (Tr. 132-134). In so affirming, only the *Pepper* v. *Litton, supra,* doctrine was applied by the Court, exemplifying the weight given that decision by the District Court.

The United States Court of Appeals (5th Circuit) affirmed the District Court in a "per curiam" opinion (Tr. 633).

Jurisdiction of the Bankruptcy Court was based under 11 U.S.C. 11 *et seq.*

REASONS FOR GRANTING THE WRIT

F. & W. Corporation, your petitioner, has argued throughout the original case and through the appeals from the findings and conclusions of the Referee that there is no evidence in the record or even an inference therein to support the conclusion that F. & W. Corporation's claim should be subordinated. There is no support for the conclusion that any of its predecessors in title ever operated, controlled, directed, or managed Capitol Tobacco Company. There was evidence that John L. Taylor, a stockholder of petitioner, owned a minority interest of stock in Capitol Tobacco Company. There was evidence that Zack D. Cravey, Sr., persuaded one J. D. McIntosh to invest in Capitol Tobacco Company. There was evidence that Fulton Properties, Inc., a corporation owned by some of the same individuals holding stock in petitioner, also owned stock in Capitol Tobacco Company. And finally there was evidence that some officers of petitioner attended one or two meetings with other persons involved in Capitol Tobacco Company.

From evidence such as set forth above, the Referee found that, even without any actual knowledge, your

petitioner, its officers and predecessors in title to the note and deed to secure debt, were responsible for false financial statements being circulated to creditors; for moneys disbursed to different places without explanation as to its purpose; for not finding corporate bookkeeping records; and for other acts of people totally unconnected with your petitioner and its predecessors in title. Your petitioner submits that no evidence has been introduced to allow the slightest inference of any form of fraudulent conduct on the part of your petitioner, its officers and predecessors in title to the note and deed to secure debt.

As stated hereinbefore, the controlling legal authority utilized in this matter was the case of *Pepper* v. *Litton*, 308 U.S. 295 (1939). It is contended that the lower courts, in this case, have extended the application of this case to a situation not intended by this Court. In addition, the United States Court of Appeals for the Fifth Circuit in the case of *Arnold* v. *Phillips*, 117 F.2d 497 (1941), speaking through Justice Foster, limited the application of *Pepper* v. *Litton*, 308 U.S. 295 (1939), to situations of fraudulent claims coupled with gross mismangement by the managing and dominating stockholder wherein the fraudulent claim was filed with the bankruptcy court by the claimant. The Court stated at page 502:

> "In both Taylor v. Standard Gas Co., 306 U.S. 307, 59 S. Ct. 543, 83 L. Ed. 669, and Pepper v. Litton, 308 U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281, extravagant salary claims were prominent. A salary debt was the entire claim of the controlling stockholder in the latter case, and so-called salaries to a subsidiary corporation were large items in the mismanagement in the former. While an extensive review of the authorities was made in the Pepper case, with a classification of them as to the remedies applied, there was no specific approval of any, but only a decision of the case before the court.

> Gross mismanagement in it and the Standard Gas case was found to require in equity a postponement of the stockholder's claims to those of other creditors, no more accurate remedy for the mismanagement appearing to be practical."

In *Pepper* v. *Litton*, 308 U.S. 295 (1939), the Court uncovered a fraudulent scheme by the controlling and dominant stockholder of a "one man or family" corporation to prevent an unsecured creditor from obtaining any satisfaction of its debt. Pepper was the unsecured creditor and Litton was the controlling stockholder. Litton, utilizing a completely false salary claim, carried on the corporate records for many years, caused the corporation to confess judgment to him personally for the claim. Pepper filed suit and obtained judgment on her past due claim. Obtaining a supersedeas for appeal from the Pepper judgment, Litton foreclosed on all assets of the corporation and removed all assets from the reach of Pepper by placing them in another corporation.

The evidence reflected that the claim of Litton was not his normal salary, which had been regularly paid, but was carried under a "personal account" and was a mere bookkeeping entry of his personal appraisal of services. Also, the claim included an assignment by an office clerk of an extravagant salary claim for the consideration of one dollar, which claim was likewise carried in a "personal account" and found to be completely false.

The Supreme Court, after discussing the general equitable powers of the Court in bankruptcy proceedings, proceeded to subordinate the claim of Litton holding him to be a director and controlling, managing officer of the bankrupt corporation, asserting a fraudulent wage claim for the sole purpose of defrauding other creditors by

utilizing the fraudulent claim to prevent an unsecured creditor from satisfying in whole or in part its unsecured claim.

As stated hereinbefore the Fifth Circuit in *Arnold* v. *Phillips,* 117 F.2d 497 (1941), limited the application of *Pepper* v. *Litton,* 308 U.S. 295 (1939), to a situation involving a fraudulent claim by a controlling and dominating stockholder, guilty of gross mismanagement of the bankrupt corporation.

In the case now before this Court, we are concerned with a note secured by a deed to secure debt which originated with the passing of consideration in the amount of Fifty thousand ($50,000.00) Dollars. This note and security deed originated with a valuable and fair consideration and passed through assignments for valuable considerations to your petitioner. The financial statements of the bankrupt corporation at all times reflected the existence of this secured indebtedness and creditors had actual knowledge of its existence (Tr. 224-228; 313-315). These creditors were R. J. Reynolds Tobacco Company and American Tobacco Company. These creditors in no way thought that mortgages on the real estate were subordinated (Tr. 224-228; Tr. 313-315). In no way were the creditors misled as to the mortgage represented by the claim of F. & W. Corporation nor were they in any way damaged or defrauded by the claim.

The great import of the rulings issued in this case revolve around their effect on the normal negotiability of notes and security deeds.

It is well to note the language of the Fifth Circuit in the case of *Arnold* v. *Phillips,* 117 F.2d 497 (1939), wherein the Court, at page 501, stated:

> "It may borrow to meet its needs. Had this corporation borrowed of a bank upon the security of the

> plant, the debt would no doubt be valid. What would render it invalid when Arnold furnished the money?"

Judge Hooper, in his opinion affirming the Referee's opinion, at page 132 of the Transcript holds in applying the doctrines of *Pepper* v. *Litton, supra*:

> "This Order . . . and was based largely upon the ruling in the case of Pepper v. Litton, 308 U.S. 295, which permitted such subordination where the conduct in question did not necessarily have to constitute fraud, but 'may be simply the violation of the rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors.' "

The above language quoting a portion of the Supreme Court's opinion is discussing a situation wherein the claim filed with the bankruptcy court arises out of a violation of the rules of fair play; a technical advantage gained wherein the claim is obtained and due to such advantage, the general creditors suffer.

In the case now before this Court, such situation did not exist. The claim of F. & W. Corporation was a valid claim in 1959 and no facts or circumstances should entitle any Court to subordinate the claim. Your petitioner is unable to find one instance wherein the existence of its claim or any actions taken by its officers or predecessors in title have damaged any creditor.

The above quoted portion of *Arnold* v. *Phillips, supra,* is what your petitioner contends to be the correct interpretation of the doctrine of *Pepper* v. *Litton, supra.* However, the District Court for the Northern District of Georgia and the Referee in Bankruptcy have disregarded *Arnold* v. *Phillips, supra,* and overextended the *Pepper* v. *Litton, supra,* doctrine.

It is contended by your petitioner that the limitation placed upon the opinion of the Supreme Court in *Pepper* v. *Litton, supra,* by the Fifth Circuit in *Arnold* v. *Phillips, supra,* is such that *Pepper* v. *Litton, supra,* could not possibly be applicable to the instant case.

With the decisions in this case now standing, a business as well as an investor are crippled in their dealings insofar as long term loans are concerned. A clarification of the import of *Pepper* v. *Litton, supra,* is needed.

In *Arnold* v. *Phillips, supra,* the Fifth Circuit went so far as to hold that the entire discussion in the *Litton* case, *supra,* did not include a specific approval of any of the decisions therein discussed and, therefore, only a factual situation as described in *Pepper* v. *Litton, supra,* would authorize an application of that doctrine.

The evidence in this case reflected that Scott Allen, Jr., James Kaufman, Robert Strauss, and J. D. McIntosh had charge of the affairs of the bankrupt corporation (Tr. 386; Tr. 244; Tr. 248). No officer of your petitioner nor its predecessors in title can be charged with running the corporation.

The findings of the Referee, in effect, are that the officers of F. & W. Corporation and one of its predecessors in title to the note and security deed, to wit: Zack D. Cravey, Sr., actually controlled, managed, owned and directed Capitol Tobacco Company, when such findings were erroneous and not supported by any evidence. Also, the Referee found that the location of missing accounting books of the bankrupt was unexplained by petitioner as well as the reason for, and location of, certain disbursed funds was unexplained by petitioner. The record is void of any evidence showing the officers of your petitioner or any of its predecessors in title to the note and security

deed to have done any act to the detriment of the bankrupt estate or creditors of the bankrupt.

Under such circumstances, in no way could the doctrine of *Pepper* v. *Litton, supra,* be extended to apply to the instant case, especially with the apparent limitation announced by the Fifth Circuit in *Arnold* v. *Phillips, supra.*

The evidence introduced in this case covered such an all encompassing realm of subjects that it is extremely difficult to set forth the many errors your petitioner contends to have been made by the Referee in his rulings on petitioner's objections. However, these are set forth in the transcript of record and relied upon by petitioner.

In many instances the Referee recognized the irrelevancy of the evidence introduced.

The Referee, after hearing testimony of several witnesses for the Trustee, observed that the evidence was not relevant and would be stricken unless subsequently connected up by the Trustee (Tr. 221; 324; 334; 342; 352; 394; and 453). There was no connecting up of this testimony and even though motions to strike were made, the evidence was allowed.

In proceedings of this type, the claimant such as F. & W. Corporation has the burden of establishing a *prima facie* case. F. & W. Corporation has done this by filing its verified claim with the Trustee in Bankruptcy, which claim was filed as a secured claim (Tr. 1-11). The Proof of Claim filed by F. & W. Corporation, as aforesaid, contained as exhibits thereto the promissory note and deed to secure debt, complete with assignments on which F. & W. Corporation based its claim. Once a *prima facie* case is established by the claimant, the burden of proof shifts to the person objecting to the claim. See citation *Missouri Printing and Engraving Company* v. *Crippen,* 224

F.2d 297; *In re Pringle Engineering and Manufacturing Company*, 164 F.2d 299; *Paschal* v. *Bluden*, 127 F.2d 398.

F. & W. Corporation shows that the burden of proof is not carried by the introduction of a mass of confused, irrelevant and inconsequential evidence. When an objection is filed to the claim of a creditor, either secured or otherwise, such objections must be supported by clear and convincing evidence. *In re Garfield Bag and Stationery Company*, 42 F. Supp. 708. In the *Garfield Bag* case, *supra*, the Court stated:

> "It is well established in bankruptcy proceedings that a verified proof of claim is prima facie evidence of the validity of the claim, and when filed, the presumption of its validity can be rebutted only by clear and convincing evidence."

Another general rule of evidence which is likewise applicable in the matter now before this Court, involves the fact that any such objection must be established and supported not by slight or inferential evidence but by a preponderance of evidence. *In re George R. Burroughs, Inc.*, 156 F.2d 640.

There is no doubt that F. & W. Corporation was a *bona fide* purchaser of the note and security deed.

In the case of *Thompson* v. *Randall*, 173 Ga. 696, a discussion of the Georgia law concerning "a bona fide purchaser" is had and certain legal principles are set forth therein which we feel are applicable to the instant case. The *Thompson* v. *Randall* case concerned a warranty deed as opposed to a deed to secure debt but the question of whether or not a particular individual was a *bona fide* purchaser was a controlling issue of the case. The Court in effect states that there must be notice of outstanding equities or restrictions, which notice must be had by both

a holder and his immediate predecessor in title. Failure of one to have such notice results in the transaction constituting a *bona fide* purchase and if value is given there is a *bona fide* purchase for value.

There has been no evidence adduced upon this hearing to show in any manner that any holder of the note and security deed from its very inception until the date F. & W. Corporation filed its claim, has had notice of an outstanding equity or other claim to this note and security deed. To hold otherwise would result in a severe restraint on normal channels of commerce such as the transfers of notes and securities such as this security deed and such a contra holding would destroy the purpose and intent of applicable negotiable instruments law. The Referee held that F. & W. Corporation was not a *bona fide* purchaser of the note and security deed (Tr. 75). Such a finding, your petitioner submits, is erroneous.

The subordination agreement (Tr. 18) executed by Fulton Properties, Inc., which the Referee held to bind your petitioner, as stated before was disregarded and in effect disapproved by the District Court.

The subordination agreement was prepared by R. J. Reynolds Tobacco Company (Tr. 235). A cardinal rule of construction requires that the agreement be construed most strongly against the party preparing the instrument. *Moorfield et al.* v. *Fidelity Mutual Life Insurance Company*, 135 Ga. 186. The Trustee in asserting this agreement on behalf of R. J. Reynolds Tobacco Company would be subject to the same rule of construction. The subordination agreement was executed by three parties, none of which ever owned or claimed any interest in the note and deed to secure debt on which your petitioner's claim was based. The three parties agreed not to ask for, demand, sue for,

take or receive from the bankrupt, payment or security with respect to any loans by these three to the bankrupt. The record reflects that the note and security deed involved in this claim did not arise from a loan to Capitol Tobacco Company by any of the signatories to the agreement. Fulton Properties, Inc., has never had any interest whatsoever in the note and security deed. R. J. Reynolds Tobacco Company, the entity in whose favor the subordination agreement was originally executed, never considered that the note and deed to secure debt upon which the petitioner's claim is based was subordinated by the subordination agreement. At no time did R. J. Reynolds Company believe that the note and deed to secure debt was a subordinated indebtedness (Tr. 230).

It is submitted that if the subordination agreement had been intended to bind other persons or corporations, such persons or corporations should have been a party thereto. In the case of *St. Louis Union Trust Company* v. *Champion Shoe Machinery Company*, 109 F.2d 313, the Court stated that bankruptcy courts may enforce subordination agreements; however, in that case as the claimant was *not* a party to the subordination agreement, he could not be bound by the agreement.

Suffice it to say that in no manner was the Referee justified in attempting to pierce the corporate veil and bind your petitioner to the terms of that agreement.

For the reasons set forth above, it is respectfully requested that this Court do grant the petition for certiorari.

WILSON, BRANCH, BARWICK AND VANDIVER

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JAckson 4-3611

By.....
Alexander E. Wilson, Jr.
Attorneys for Petitioner

CERTIFICATE OF SERVICE

I do hereby certify that I have this day served a copy of the foregoing petition for certiorari on counsel for Respondent by mailing same in the U. S. Mail in an envelope with sufficient postage, to:

Messrs. Chas. Kirbo and Wm. H. Izlar
King & Spalding, Attorneys
Fourth Floor, Trust Company of Georgia Building
Atlanta, Georgia 30303

This ..... day of February, 1965.

.....

APPENDIX

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 21,509

F & W CORPORATION,
Appellant,

vs.

CHARLES M. LOKEY, TRUSTEE IN BANKRUPTCY FOR CAPITOL TOBACCO COMPANY,
Appellee.

Appeal from the United States District Court for the Northern District of Georgia

(November 30, 1954)

Before Jones and Wisdom, Circuit Judges, and Hunter, District Judge

PER CURIAM: A careful review of the record has convinced the Court that no reversible error has been committed. The judgment of the District Court is

AFFIRMED.

United States Court of Appeals

FOR THE FIFTH CIRCUIT

OCTOBER TERM, 1964

No. 21,509

D. C. Docket No. 39971—Bankruptcy

F & W CORPORATION,
Appellant,

vs.

CHARLES M. LOKEY, TRUSTEE IN BANKRUPTCY FOR CAPITOL TOBACCO COMPANY,
Appellee.

Appeal from the United States District Court for the Northern District of Georgia

Before Jones and Wisdom, Circuit Judges, and Hunter, District Judge

Judgment

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Georgia, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed;

It is further ordered and adjudged that the Appellant, the F & W Corporation, be condemned to pay the costs of this cause in this Court for which execution may be issued out of the said District Court.

November 30, 1964

Issued as Mandate: Dec 23, 1964